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Fund =
Company =
Advisor =
Sub-Advisor =
State =

This responds to your request for a ruling dated July 20, 2012, and subsequent correspondence, submitted on behalf of Fund. Fund requests a ruling that income from the CPI swaps (as defined below) will constitute other income derived with respect to Fund's business of investing in stock, securities, or currencies, and therefore will constitute qualifying income under section 851(b)(2).

Fund is a series of Company, a State corporation registered as an open-end investment company under the Investment Company Act of 1940, 15 U.S.C. 80a-1 et. seq., as amended (the “1940 Act”). Fund represents that it seeks annually to qualify as

a regulated investment company (“RIC”) under subchapter M of the Code. Fund is advised by Advisor and Sub-Advisor.

Fund’s investment objective is to pursue total return using a strategy that seeks to protect against United States (“U.S.”) inflation. U.S. inflation equates to a diminished value of the U.S. dollar. Under normal circumstances, Fund invests substantially all of its assets in debt obligations, which Fund represents are “securities” under section 851(b)(2). Because the interest and principal of Fund’s debt obligations are repaid in U.S. dollars, inflation causes a decrease in the value of Fund’s debt obligations.

Fund may seek to reduce the effects of inflation on some or all of its debt obligations by entering into swap contracts based on the Consumer Price Index Urban Non-Seasonally Adjusted (“CPI-U NSA”) or the Chained Consumer Price Index for All Urban Consumers (“C-CPI-U”) (“CPI Swaps”). Both indices are published by the U.S. Bureau of Labor Statistics and are regarded as measures of inflation. The CPI-U NSA is a non-seasonally adjusted measure for estimating inflation by referencing changes in the price levels for urban consumers of a standard basket of goods and services. The C-CPI-U is similar to the CPI-U NSA except that the C-CPI-U reflects changes in the types of items that consumers might purchase as prices change. The CPI Swaps are fixed maturity derivatives in which the counterparty receives the “realized” rate of inflation as measured by the applicable CPI over the life of the swap. Some of the CPI Swaps could involve two or more payments over the term of the swap, whereas other CPI Swaps will have a “bullet” structure, where all cash flows are exchanged at maturity.

Fund represents that it enters into the CPI Swaps primarily to manage or reduce the effects of inflation on some or all of the debt obligations it owns. The inflation indexed payments Fund receives under the CPI Swaps offset in whole or in part the effect of inflation on its debt obligations. Fund is an actively managed RIC, and, as such, the CPI Swaps are entered into, maintained and exited based upon on-going portfolio management decisions. However, Fund has represented that the notional amount of the CPI Swaps generally will not exceed an amount reasonably calculated to reduce Fund’s level of risk with respect to its investment in debt obligations. This representation will be satisfied if the total notional amount of the CPI Swaps generally will not exceed the total fair market value of its debt obligations.

Law:

Section 851(a) of the Code defines a RIC, in part, as a domestic corporation registered under the 1940 Act as a management company.

Section 851(b) of the Code limits the definition of a RIC to a corporation meeting certain election, gross income, and diversification requirements.

Section 851(b)(2) of the Code provides that a corporation shall not be considered a RIC for any taxable year unless it meets an income test (the “qualifying income requirement”). Under this test, at least 90 percent of its gross income must be derived from certain enumerated sources (such income is referred to as “qualifying income”).

Prior to the enactment of the Tax Reform Act of 1986 (the “1986 Act”), section 851(b)(2) of the Code identified qualifying income as “dividends, interest, payments with respect to securities loans (as defined in section 512(a)(5)), and gains from the sale or other disposition of stocks or securities.” Section 851 did not contain its own definition of the term “securities,” but section 851(c)(5) provided that, for the purposes of section 851(b)(3) (the “asset diversification test”), “[a]ll other terms shall have the same meaning as when used” in the 1940 Act.¹

The 1986 Act expanded the meaning of qualifying income under section 851(b)(2) in a number of ways: (1) by adding an explicit cross-reference to the definition of “securities” in the 1940 Act; (2) by adding gains from the sale or other disposition of foreign currencies; and (3) by adding an “other income” provision. As so amended, qualifying income under section 851(b)(2) includes, in relevant part –

. . . dividends, interest, payments with respect to securities loans (as defined in section 512(a)(5)), and gains from the sale or other disposition of stock or securities (as defined in section 2(a)(36) of the Investment Company Act of 1940) or foreign currencies, or other income (including but not limited to gains from options, futures or forward contracts) derived with respect to its business of investing in such stock, securities, or currencies. . . .

Section 2(a)(36) of the 1940 Act defines the term “security” as –

. . . any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security”, or any certificate of interest or participation in, temporary

¹ Section 851(c)(5) of the Code was redesignated as section 851(c)(6) by the American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 331(c) (10-22-2004).

or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Analysis:

In analyzing whether a derivative financial instrument generates qualifying income under the “other income” clause of section 851(b)(2), we examine the relationship between the income or loss generated by the derivative and the RIC’s business of investing in stock, securities, or currencies. In conducting this analysis, we must also consider the legislative history accompanying the 1986 enactment of the other income provision to determine Congressional intent.

Relationship of Income from the CPI Swaps to the RIC’s Business of Investing in Stock, Securities, or Currencies

Income and gain from the CPI Swaps may be other income that is qualifying income to Fund, if the income and gain is derived with respect to Fund’s business of investing in stocks, securities, or currencies. As noted above, Fund invests substantially all of its assets in debt obligations, which Fund represents are “securities” under section 851(b)(2).

Fund represents that its purpose in investing in the CPI Swaps is to protect against losses in the value of its debt obligations due to inflation, and further that its position in the CPI Swaps is reasonably calculated to reduce Fund’s inflation risk with respect to its investment in debt obligations. The inflation indexed payments Fund receives under the CPI Swaps are intended to reduce the effects of inflation on its debt obligations. The payments that Taxpayer expects to receive from the CPI Swaps and corresponding decreases in the inflation- adjusted value of Taxpayer’s debt obligations demonstrate the requisite relationship between the income generated by its positions in the CPI Swaps and its business of investing in debt obligations.

Fund has represented that the notional amount of the CPI Swaps generally will not exceed an amount reasonably calculated to reduce Fund’s level of risk with respect to its investment in debt obligations. This representation will be satisfied if the total notional amount of the CPI Swaps generally will not exceed the total fair market value of its debt obligations.

Controlling Statutory Language

In amending section 851(b)(2) in 1986, Congress inserted parenthetical language that specifically enumerated gains from futures contracts (as well as gains from options and forward contracts) as a type of income that may constitute other income derived with respect to a RIC’s business of investing in stock, securities, or currencies. Congress specifically noted that the Service had previously ruled favorably under

section 851(b)(2) on income from futures contracts (131 Cong. Rec. 24570-71 (1985)), creating a strong inference that the statutory language should be interpreted in a manner consistent with those prior rulings.

The pricing and economics of the CPI Swaps at issue are similar to those of the futures contracts enumerated in section 851(b)(2) and discussed in the legislative history to that provision. Income from the CPI Swaps therefore falls within a category of income which Congress intended to include as qualifying income under the other income provision if derived with respect to the RIC's business of investing in stock, securities, or currencies.

Passive Nature of Income

Congress has explained that the favorable RIC tax provisions are intended for passive investment entities that do not engage in active business and that a RIC's investments should be limited to income from stocks and securities, as opposed to other property. STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 (1987), at 377. A letter by J. Roger Mentz, Acting Assistant Secretary of the Treasury (Tax Policy) ("the Mentz letter"), explained the fundamental policy served by the qualifying income requirement:

. . . First, income qualifying under section 851(b)(2) should be limited to income from property held for investment, as opposed to property held for sale to customers in the ordinary course of business. Second, income qualifying under section 851(b)(2) should be limited to income from stocks and securities, as opposed to other property. . . .

132 Cong. Rec. 4048 (1986) (remarks of Senator Armstrong, inserting letter of J. Roger Mentz, Acting Assistant Secretary of the Treasury (Tax Policy), dated February 5, 1986, to Rep. Flippo).

The trading of securities held by a RIC for investment is treated as passive in nature. *Id.* Here, the income and gain generated by Fund from investments in the CPI Swaps are also passive in nature, similar to those generated by investments in stock and securities within the meaning of section 851(b)(2).

Policy Limitation on Investment in Commodities

As noted above, Congress has explained that a RIC's investments should be limited to income from stocks and securities. With respect to commodities, the Mentz letter states that "...we would generally not treat as qualifying income gains from trading in commodities, even in the purpose of that trading is to hedge a related stock investment." *Id.*

Although the CPI-U NSA and the C-CPI-U, the underlying referents for the CPI Swaps, include the value of certain baskets of commodities in measuring the average change in prices over time of goods and services of urban consumers, the annual percentage change of the CPI-U NSA and the C-CPI-U is predominantly used as a measure of inflation. Thus, a position in a derivative referencing the CPI-U NSA or the C-CPI-U is not predominantly an indirect investment in commodities.

Conclusion:

Assuming that Fund's debt obligations are "securities" under section 851(b)(2), income and gain derived from the CPI Swaps constitute other income derived with respect to Fund's business of investing in securities within the meaning of section 851(b)(2) of the Code, provided that the notional amount of the CPI Swaps generally will not exceed an amount reasonably calculated to reduce Fund's level of risk with respect to its investment in its debt obligations. This will be satisfied if the total notional amount of the CPI Swaps generally will not exceed the total fair market value of Fund's debt obligations.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. In particular, no opinion is expressed whether Taxpayer otherwise qualifies as a RIC under part I of subchapter M of Chapter 1 of the Code, whether Taxpayer's debt obligations constitute securities under section 851(b)(2), or whether gains generated by Taxpayer's CPI Swaps may also constitute qualifying income under section 851(b)(2) as gains from the sale or other disposition of stock or securities (as defined in section 2(a)(36) of the 1940 Act).

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

David B. Silber
David B. Silber
Branch Chief, Branch 2
Office of Associate Chief Counsel
(Financial Institutions & Products)